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No. 88-2133

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

GEORGE PRUSSIN and SHARON PRUSSIN,

Respondents.

BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

In determining proper deductions from income for income tax purposes following a sale of property:

1. Can the Internal Revenue Service eliminate all deductions in their entirety to the buyer if they are based upon a value which it determines "greatly exceeds the fair market value," or is the taxpayer entitled to modified deductions based upon "fair market value" as ultimately determined?

2. Is the refusal to allow any deductions at all as a consequence of a claim of deductions based upon a value which "greatly exceeds fair market value," the assertion of an unconstitutional penalty?

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The respondents, George Prussin and Sharon Prussin, sometimes referred to herein as the taxpayers, respectfully urge this Court to deny the Commissioner's petition for *certiorari* to the United States Court of Appeals for the Third Circuit.

The decision of the Third Circuit was correct and consistent with the views of the three other circuit courts which have expressed a view on the issue.

STATEMENT OF THE CASE

The transactions which gave rise to this litigation involve a real estate syndication known as Pleasant Summit Associates (PSA), a limited partnership. The promoter through a corporation, Pleasant Summit Land Corporation (PSLC), had purchased the real property in question for $4,200,000 in an arms-length transaction and shortly thereafter through another corporation sold it to PSA which he controlled for $7,759,200, largely with nonrecourse debt, partly paid and partly assumed from earlier transfers (C.A. App. 5a, 19a-21a, 615a-20a, 632a).[1] The investors who purchased the limited partnership interests agreed to pay $1,980,000 in cash installments for the equity (C.A. App. 625a). The promoter had anticipated that he could convert the property to condominiums or cooperatives, a change prevented by a revision of local law (C.A. App. 61a-64a). For that and various other reasons, the property was sold in an arms-length transaction for approximately $7,000,000 eight years later (C.A. App. 134a-35a).

For purposes of the income tax liability of the selling corporation, the nonrecourse obligations were treated by the Commissioner of Internal Revenue at face value, and accordingly, PSLC was taxed based upon a gain of $3,742,704 (C.A. App. 188a-89a). The purchasers of the limited partnership participations claimed deductions for interest and depreciation based upon the purchase price, $7,759,200. The Internal Revenue Service, however, took the position that the "fair market value" of the property was only $4,200,000.

Based upon the claim by the Commissioner of Internal Revenue, affirmed by the Tax Court, that the price paid for the property, treating the nonrecourse indebtedness incurred in connection with the purchase at its face value, "greatly exceeded fair market value," the Commissioner disallowed any interest and depreciation deductions ordinarily permitted in the computation of taxable income. On appeal from the Tax Court, the Third Circuit ruled that the taxpayer was entitled to deductions

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[1] Citations to pages in parenthesis prefaced by "C.A. App." are to the record in the Third Circuit.

based upon the actual fair market value. The government now petitions this Court for *certiorari* asserting that the rule followed by the Third Circuit is in error.

As the government points out, the Tax Court decision involved taxpayers located in the Second and Third Circuits. The amount involved in the Second Circuit (*Estate of Isaacson v. Commissioner*, 860 F.2d 55 (1988) (*per curiam*)) was trivial, and the taxpayers sought the agreement of the government to a consolidation of the appeals in either the Second or the Third Circuit, the choice to be made by the government. The government declined to consolidate. The small matter in the Second Circuit was argued first, and the court merely affirmed *per curiam* the opinion of the Tax Court. This was communicated by the government to the Third Circuit which thereafter handed down a lengthy, detailed and carefully reasoned opinion reversing the Tax Court decision.[2] It is from this Third Circuit opinion that the government now appeals alleging a conflict between the circuits.

It is apparent from the government's petition that it is seeking the support of this Court for an extension of its authority, not authorized by statute, to punish taxpayers by disallowing any deductions in the event that a taxpayer had claimed deductions based upon "a value which greatly exceeded fair market value."

As we will show, and as the Third Circuit opinion makes clear, the opinion rejecting the government's position from which an appeal is sought is not in conflict with opinions in other circuits. And if the government wants authority to assert punishment as a way of dealing with so-called "tax shelters," it should

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[2] The taxpayers presented as their main issue for review to the Second and Third Circuit "whether deductions by the [taxpayers], who had invested in the real estate syndicate, for interest on nonrecourse indebtedness and depreciation can be completely disallowed based on a claim that the real property that was purchased by a syndicate for more than the 'fair market value' thereof." Although the Department of Justice filed a 47 page brief in this case, its sole comment on this issue was on page 46 and only in a footnote. The Department of Justice concluded, it seems, that if it ignored the issue, perhaps the court would too, a strategy which may have worked in the Second Circuit but failed in the Third.

obtain, as it has in the past, such authority from Congress and not by judicial legislation.

REASONS FOR DENYING THE PETITION

1. *No Reason For Certiorari Exists.* Rule 17 of the Rules of the Supreme Court of the United States provides that *certiorari* will be granted only where there are "special and important reasons therefor." *Layne & Bowler Corp. v. Western Well Works, Inc.*, 261 U.S. 387, 393 (1923), stated that *certiorari* is appropriate only when there is "a real and embarrassing conflict of opinion and authority between the circuit courts of appeal." See also *Rice v. Sioux City Cemetary*, 349 U.S. 70 (1955).

2. *There Are No Conflicting Opinions Here.* There are no conflicting opinions in the circuit courts. In fact, those which expressed their view are in accord with the opinion of the Third Circuit which the government seeks to have reviewed. Specifically, there is no conflict with *Odend'hal v. Commissioner*, 748 F.2d 908 (4th Cir. 1984), *cert. denied*, 471 U.S. 1143 (1985), or *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), as will be seen when the merits are discussed below, and the only possible conflict is with *Estate of Isaacson*, *supra*, in the Second Circuit. However, the opinion in *Estate of Isaacson* does not conflict with the opinion in this case. The Second Circuit chose to write only a brief *per curiam* opinion, and affirmed based on the opinion of the Tax Court below. The Tax Court relied on *Estate of Franklin* in sustaining the government, and its opinion contained no reasoned discussion of the taxpayer's contention that partial deductions for interest and depreciation should be allowed. The government has conceded, albeit not in this Court and albeit reluctantly, that there is language in *Estate of Franklin* supporting the taxpayer's view.[3] A different result

[3] In its petition in the Third Circuit for rehearing when it first chose to address the taxpayer's argument, the government stated: "To be sure, there is language in the opinions of both *Odend'hal* and *Estate of Franklin* which, taken out of context, could be read as consistent with the panel opinion here." Petition For Rehearing In Case No. 88-1377 By The Commissioner of Internal Revenue, p. 6.

was reached in *Estate of Isaacson* than was reached by the Third Circuit, but neither the Tax Court nor the Second Circuit chose to reveal their reasoning. Therefore it is wrong to contend that a conflict exists between circuits, much less a "real and embarrassing conflict." The purpose of the government petition is not to resolve a conflict, but to obtain the right to exact penalties without statutory authority.

3. *Other Circuit Opinions Take The Same View As The Third Circuit.* The government's discussion of *Odend'hal* and *Estate of Franklin* in its petition is flawed and conceals more than it reveals. In fact, both those cases, as well as *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984), directly support the Third Circuit's view as it pointed out in its opinions.

First, as noted by the Third Circuit in its opinion on the petition for rehearing, in both *Odend'hal* and *Estate of Franklin*, "as the Commissioner seems to acknowledge," the issue of whether the taxpayers were entitled to partial deductions was not raised either before the Tax Court or on appeal.

As the *Odend'hal* opinion states, the Service did not disallow *all* of the deductions for interest and depreciation claimed by the taxpayers. Rather, the Service permitted the taxpayers to claim deductions equal to the income from the property. Thus, the facts in *Odend'hal* give no support whatsoever to the government's contention that *Odend'hal* should be read as supporting the rule which they advance in this case.

Second, not only do the facts contradict the government's claim, but a reading of the Fourth Circuit's opinion reveals that it is consistent with the views of the Third Circuit in this case. At 748 F.2d 912 the Fourth Circuit recites what it understands the governing rule to be, citing *Brannen* and *Estate of Franklin*. It states that if the fair market value of the property is less than that financed by a nonrecourse loan, "the authorities hold that the principal of the nonrecourse loan *which exceeds fair market value* does not represent a real investment in the property by a taxpayer and he may not include that nonrecourse amount in his basis for depreciation." (Emphasis added.) It concludes

its statement of the rule with: "But if the stated price financed by the nonrecourse debt exceeds the fair market value of the property, *to the extent of the excess*, the taxpayer has no equity in the property to protect and no economic incentive to pay off the debt." *Id.* (Emphasis added.)

The government's claim that the views of the Fourth Circuit in *Odend'hal* conflict with those of the Third Circuit in this case is specious.

The rule applied in this case by the Third Circuit was also applied by the Eleventh Circuit in *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984). As the Eleventh Circuit ruled: "Where the stated purchase price of the property securing the note exceeds a reasonable estimate of the property's existing fair market value, no actual investment exists *as to the excess* since the purchaser would be acquiring no equity in the property by making payments and therefore would have no economic incentive to pay off the note. *Estate of Franklin*, 544 F.2d at 1048." 722 F.2d at 701 (emphasis added). In *Brannen* the estimated fair market value of the property in question, a movie, was found to be less than the amount of cash paid for it. Therefore, a disallowance of depreciation deductions all of which were attributable to the nonrecourse indebtedness was sustained by the Eleventh Circuit. However, this was clearly in the context of the rule quoted above that there is no equity only to the extent the mortgage exceeds fair market value. This view is consistent with the Third Circuit's holding in this case.[4]

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[4] This approach is supported by Section 1274 of the Internal Revenue Code, effective for purchases after March 1, 1984, which determines the issue price (or imputed principal amount) of certain debt obligations issued for property. The purpose of Section 1274 is to be sure that interest payments do not masquerade as principal. Thus, if an inadequate rate of interest is provided for, the face of the amount of the debt is reduced for tax purposes and some of the purported principal payments are treated as interest.

Section 1274 applies specifically to tax shelter and other situations "having potential for tax avoidance." Section 1274(b)(3)(B). Regulation Section 1.1274-3(c)(2), Example (3), deals with a property with a fair market value

(*Footnote continued*)

The origin of the rule regarding the disallowance of interest and depreciation relating to nonrecourse liability in excess of the fair market value of property was the 1976 Ninth Circuit case, *Estate of Franklin v. Commissioner*, 554 F.2d 1045 (9th Cir. 1976), *affirming on different grounds*, 64 T.C. 752 (1975). However, as indicated by the citation by *Odend'hal* and *Brannen* of *Estate of Franklin*, it too supports the position of the Third Circuit.

In *Estate of Franklin*, the owner of a motel agreed to "sell it" for $1,225,000, reflected entirely in a nonrecourse mortgage. The buyer agreed to pay $9,045.36 a month as principal and interest installments on the obligation and there was a balloon payment at the end of ten years in the amount of $975,000. The property was leased back to the seller for a net monthly rental in the same amount as the monthly principal and interest installment. The seller was responsible for operating the motel and meeting all expenses and the deed was never recorded. The only cash payment by the buyer was $75,000 of "prepaid interest." Accordingly, for the $75,000 payment the investors sought to claim depreciation deductions for ten years and at the end of ten years had the option of paying the remaining balance

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of $7 million which is sold for $8 million, $1 million cash down and debt of $7 million. Regulation Section 1.1274-4(h), Example (2), on these facts states the imputed principal amount (the issue price) of the debt is $6 million, the value of the property ($7 million) reduced by the down payment ($1 million). Regulation Section 1.1274-2(a) states that the cost basis of property acquired for a debt instrument is the issue price (the imputed principal amount), or $6 million in the example above.

Neither Section 1274 nor the regulations suggest that debt issued for property is to be *totally* disregarded if it exceeds the fair market value of the property. On the contrary, the statute and the regulations have the effect of recognizing debt to the extent equal to fair market value and providing depreciable basis to that extent.

Thus, Congress and the Internal Revenue Service have recognized that the approach of the Third, Fourth, Ninth and Eleventh Circuits is correct and that the approach which the Commissioner is attempting to establish in this case is wrong.

of $975,000 and taking title to the motel or walking away from the deal.

In *Estate of Franklin*, the deductions had been disallowed by the Commissioner on the ground either that the acquisition was a sham or it was in substance the acquisition of a ten year option to purchase the motel for $975,000. Therefore, the purported buyer was not entitled to take deductions because it assumed none of the burdens, obligations, or risks of an owner who made an investment in the property. The Tax Court sustained the disallowance on the basis that the transaction constituted an option, and the Ninth Circuit affirmed, albeit taking a different approach.

The Ninth Circuit decided the case on the basis of a failure of proof, *i.e.*, the Tax Court explicitly found on the facts before it that the value of the property could not be estimated and the Ninth Circuit regarded this defect in the taxpayer's proof as fatal. Since no fair market value was known, all the indebtedness necessarily was in excess of fair market value. Therefore total disallowance was approved.

As noted above, the government has conceded that there is language in the opinion of *Estate of Franklin* which is consistent with the Third Circuit decision. The Fourth Circuit in *Odend'hal*, the Eleventh Circuit in *Brannen*, and the Third Circuit in the case at bar have interpreted *Estate of Franklin* as establishing the rule of law which the Third Circuit applied in this case.

Thus, none of the cases relied on by the government support its claims. Moreover, the arguments it offers in support of its stand that this uniformly established view of the law is unsound are equally deficient.

The government argues that the hypothetical transaction on which the Third Circuit based its decision justifying partial deductions is entirely speculative. It adds that because the amount of nonrecourse indebtedness to be taken into account is fixed at the time of acquisition, and there will be either a rise or

a fall in the value of the property, the validity of the Third Circuit's analysis is suspect.

The problem with the government's argument is that all of the rules of law with respect to mortgages are based on hypothetical assumptions which may or may not be valid. For example, under the government's rule, the taxpayer in this case would be entitled to no deductions for interest and depreciation because his partnership made no investment in the property. Yet, in fact, the taxpayer made a substantial cash investment in the partnership and the partnership owned the property up until December 1985, and made regular principal and interest payments of over $21,000 per month on one of the nonrecourse mortgages (C.A. App. 61a-62a, 660a), and minimum yearly payments of $320,000 on the other two mortgages (C.A. App. 61a-62a, 594a, 607a). Although not required by the mortgages, the offering memorandum represented that investors' payments after the initial year would be used to reduce the principal of the mortgages (C.A. App. 711a) and the cash flow projections which were part of the offering circular showed mortgage amoritization of $462,000 for 1979, $396,000 for 1980 and so on (C.A. App. 849a). And in 1985, the partnership did not default, but rather sold the property to an unrelated party.[5] Yet the government is quite prepared to disregard these facts in favor of its hypothesis that the taxpayer had no interest in this investment other than for the tax benefits. In fact the taxpayers had paid over $500,000 in cash for their interest in the partnership (C.A. App. 365a, 393a, 479a). This was not a "free ride."

This Court's decision in *Crane v. Commissioner*, 331 U.S. 1 (1947), is equally hypothetically based. In *Crane* the conclusion of this Court that, in determining the amount realized on

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[5] The plan of PSA, the partnership, in purchasing the property was to turn it into a cooperative or condominium and thus enhance its value, a plan frustrated by a subsequent change in local law (C.A. App. 705a, 61a-64a). Despite this change in circumstance and the normal depreciation of the building, the property purchased in May of 1978 by the partnership for $7,759,200 was sold at the end of 1985 to an unrelated third party for $7 million (C.A. App. 134a-35a).

the sale of property, any nonrecourse mortgage was required to be included, at least if the value of the property was more than the amount of the mortgage, is based on the hypothesis that Mrs. Crane would not have sold property worth over $250,000 for only $2,500. 331 U.S. at 13.

Crane also relied on the hypothesis that an owner of property subject to nonrecourse debt less than its fair market value "will treat the conditions of the mortgage exactly as if they were his personal obligations." 331 U.S. at 14.

The conclusion that a purchaser of property who gives a small amount of cash and a purchase money mortgage is entitled to depreciate the full fair market value of the building is based on the hypothesis that the debtor, even if not personally responsible for the debt, will make payments on the mortgage to retain possession of the property and to protect the cash paid already.[6]

This Court in *Commissioner v. Tufts*, 461 U.S. 300 (1983), held that a seller of property subject to a nonrecourse mortgage at a time when its fair market value had declined below the face of the loan was nonetheless required to include the full amount of the nonrecourse obligation in the amount realized on the sale. This holding is based on the hypothesis that the seller had an obligation to repay the mortgage. 461 U.S. at 310, n.8. When extinguished, the mortgage must be treated as an amount realized.[7]

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[6] See *Commissioner v. Tufts*, 461 U.S. 300, 309 (1983) ("The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay.").

The government's desire to distinguish *Tufts* as it does in footnote 5 on page 13 is understandable. There is language in *Tufts* inconsistent with the government's basic position that a mortgage in excess of fair market value is not includible in basis. This Court stated in *Tufts* that its holdings in *Crane* were that "the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant." 461 U.S. at 307.

As was aptly said by the Third Circuit in its opinion on rehearing: "While the Commissioner dismisses the compromise possibility as 'entirely speculative' and 'wholly unpredictable at the time the borrower acquires the property subject to the nonrecourse note' his argument proves too much because the concept of disallowance of the deductions in excess non-recourse financing situations is based on the theoretical economic disincentive to the borrower to pay the debt rather than upon what ultimately happens. It is no more speculative to assume that the lender will act rationally in compromising than it is to assume that the borrower will not foolishly pay the entire nonrecourse debt." Appendix to Petitioner's Brief at 37a.

The government argues, but fails to explain, that the decision of the Third Circuit will produce "grave inequities in tax administration" because it will cause a serious disruption in the efforts of the Internal Revenue Service to achieve a prompt and fair disposition of a large number of tax shelter cases. Possibly the Commissioner is contending that applying the law as enunciated by the Third, Fourth, Ninth and Eleventh Circuits is too much of a burden. More likely the Commissioner is contending that the *in terrorem* effect of a loss of all deductions will discourage taxpayers from any challenge. But if this is the theory, it flies in the face of past experience. The Commissioner is contending that the rule he wishes enunciated is the rule that previously has been applied everywhere. However, the *Brannen*, *Odend'hal*, and *Estate of Franklin* cases amply demonstrate that taxpayers will litigate when the Service claims that the fair market value of the property purchased is significantly less than the nonrecourse indebtedness incurred in connection with the purchase. That same issue was in dispute in this case.

What the Commissioner really wants is a rule that will cost the government less revenue by eliminating deductions. Because, whatever the rule of law is, it will do nothing to lessen litigation or encourage settlements.

The government also expresses concern for the potential disparities in tax treatment arising from the varied holdings in the courts of appeal. There is, of course, no such potential in

our view because all the circuits which have expressed an opinion are consistent in their statement of the rule. However, the government should have reflected on potential disparities in tax treatment somewhat earlier, perhaps when it refused to consolidate the *Prussin* and *Isaacson* cases in the Second or Third Circuit on appeal or when the Internal Revenue Service settled ten cases related to this one on one basis, but declined to settle Mr. and Mrs. Prussin's case on a similar basis.[8]

Moreover, in view of the government's concern for disparities in tax treatment, if this Court should decide to grant *certiorari* in this case, we ask this Court to exercise its general equitable jurisdiction and review with this case the decision of the Second Circuit in *Isaacson v. Commissioner* so that, whatever the outcome in this Court, at least Messrs. Prussin and Isaacson will be treated similarly.

Absent from the Commissioner's petition is any recognition that the nonrecourse indebtedness it seeks to have disregarded for the buyer was taken into account at full face value in the computation of the gain realized by the seller. The nonrecourse mortgages involved in this transaction, which were disregarded by the Tax Court in determining the interest and depreciation deductions which could be claimed by PSA, were treated at face value by the Internal Revenue Service and the courts below as amounts realized by PSLC on the sale to its subsidiary and gain was computed and tax paid on this basis. This is yet

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[8] The individual investor who owned PSLC which acquired the property in an admittedly arms' length transaction engaged in the same period in ten other essentially identical real estate transactions, all of which were challenged by the Internal Revenue Service. The Internal Revenue Service settled ten of these transactions on essentially the same basis as that mandated by the Third Circuit, including three that were settled after the trial of this case. In the ten cases, interest and depreciation deductions were permitted to the extent of fair market value based on the original cost of the property, plus 12%. The office of the Internal Revenue Service handling this case refused to settle this case and to follow the settlement of the other ten cases, even though there were investors who were partners in both PSA and these other partnerships.

another disparity in treatment the government chooses to overlook.[9]

4. *A Grant of Certiorari Will Raise A Constitutional Issue.* The final reason for rejecting the petition is that the Commissioner's position presents a constitutional question whereas the circuit courts' rule does not. It is the taxpayer's contention, supported by cases in this Court, that the Commissioner's denial of all deductions because it disagrees with the amount claimed constituted a penalty and a taking without due process in contravention of the Fifth Amendment to the Constitution.

This question was not reached by the Third Circuit in view of its decision rejecting the government's contentions. But, should *certiorari* be granted, the taxpayer would renew his contention on this point in this Court.

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[9] Nor does the Commissioner deal with what happens following the disregard of nonrecourse indebtedness on a taxpayer's purchase when the taxpayer resells the property. Any nonrecourse indebtedness disregarded on the purchase as not representing true indebtedness should not be regarded as true indebtedness on a subsequent sale, even though the fair market value of the property is substantially in excess of what it was at the time the amount of the indebtedness to be disregarded was determined. If the government is truly interested in correcting disparities in treatment, it should assure this Court that it will follow the above rule and not disregard indebtedness at the outset, but treat it as valid on a subsequent sale. It should also assure this Court that if it disallows depreciation deductions to a buyer it will in such cases allow them to the seller. The depreciation of a building should be allowed to somebody.

CONCLUSION

There is no legal or factual basis for the grant of a writ of *certiorari* and the petition for such writ should be denied.

Respectfully submitted,

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